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Economic Conditions Governmental Finance United States Securities



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The United States At War

THE shock of the tremendous events which plunged the United States into the war, and the grave anxiety of the days following, have been sustained by people of all sections with an impressive showing of unity and resolution. The country was unprepared for sudden assault. In order to give aid to the nations attacked by the Axis, it had accepted the risk of involvement in the war, but people naturally hoped that aid short of war would be effective. They were sympathetic with the Allied cause, increasingly convinced that our own security would be imperilled by Allied defeat, and devoted to the principles of democracy, freedom from aggression or oppression, and respect for public law. All these principles have been outraged by the Axis powers. On the other hand, the country was removed from the war scene. It had no old grievances to inflame it and no selfish ambitions to gratify, and was by disposition unmilitary and inclined to peace, order and friendly trade. It cared so little for its neutral rights that it voluntarily surrendered many of them by congressional enactment. It had from 1917 onward a hard lesson of the waste and destruction of war, the inestimable costs in life and wealth, the disruption of normal activity and the aftermath of debt, disorganization and depression.

In daring to bring the United States with all its resources into the war against them, the Axis powers undoubtedly counted upon division of national sentiment to weaken our war effort, and upon what they conceive to be the cumbersomeness and inefficiency of democracy to make us ineffective until too late. In their first hope they are already proved mistaken. The assault on Pearl Harbor wiped out all scruples against joining in the conflict. It established the fact of danger to the country and of stupendous tasks ahead, and assured the subordination of differences to the single purpose of fighting the war. No other move of the Axis could have had a like effect on the American people. This unity is of incalculable value in facing the problems of the months to come.

President Roosevelt moved with exemplary promptness to ask for the declarations of war. The nation being under attack, no extensive address to Congress or recapitulation of the country's position in relation to the war was required; and the immediate and practically unanimous vote (one dissenting) provides a contrast to the fifty-six dissenting votes to the war declaration in 1917. Unquestionably the Government was not only performing its duty of providing for the common defense, but was reflecting the universal feeling.

It is equally gratifying and significant that the position taken by the United States has won the sympathetic support of the Latin-American states. Cuba, Panama, Costa Rica, Nicaragua, Guatemala, Honduras, El Salvador, the Dominican Republic and Haiti have joined the United States in declaring war against the Axis; Mexico and Colombia have severed diplomatic relations; and from all countries have come expressions of a community of interest and endorsement of our action. The value of the war declarations cannot be underestimated, in view of the strategic location of these countries in relation to the Panama Canal and the importance of preventing fifth-column activity in them. Argentina, Brazil, Chile and Uruguay have granted us the standing of a non-belligerent, which will be of great assistance in case of naval action around South America. Apart from this practical aid, the evidence of solidarity of opinion is deeply pleasing. It is plain that the Latin-American countries recognize that our purposes in entering the struggle are disinterested, and defensive in the broad as well as the narrow sense.

The Single Aim of National Policy

There is now but one object of national policy, namely, to bring the war to a successful conclusion, in conjunction with our Allies, as quickly as possible. Every energy and national resource which can be devoted to that end should be so devoted. It must be understood that war is the principal business of the country, and that it may be shortened and an untold number of lives saved if we enter it in that

spirit. Loyal support can be taken for granted, and if understanding of the dangers, duties and responsibilities is as widespread as loyalty there will be no fear as to the effectiveness of our effort.

The first essential is to recognize the magnitude of the struggle, the long start the Axis powers have had, the initial advantages they have gained, and the possibility of grave reverses before we catch up. The extent of the conflict defies comprehension, for it involves 90 per cent of the world's people. Our own defenders are fighting in the Philippines, 7,000 miles from San Francisco. The armies of our Allies range from the East Indies through Africa and the Near East to the British Isles and to the Arctic coast of Russia.

The war is a single conflict, and the interest of all requires that it be fought as such, with the common resources distributed for their most efficient use. Moreover, it is a total war; there will never be all the munitions and equipment that could be employed. Speed in production is vital, for tanks and planes are needed to protect essential raw materials from the Axis, which will be able to prolong the struggle if it obtains them. Finally, no one can foretell the duration of the conflict. Hence production programs must contemplate a long war.

This country has been moving toward a war economy for eighteen months, in the past few months very rapidly. The change that is now wanted is therefore not one of kind but of degree, to step up the production pace by giving the war effort an even greater priority. Probable defense expenditures for the year 1942 had been commonly estimated as in the range of \$25 to \$30 billions, representing a steady increase from the current rate of some \$20 billions, and comparing with the 1941 total of \$12.5 billions. Now a bigger goal, up to \$40 billions if the production can be had, is being established. The armed forces will be increased. The war industries will be expanded and use more materials, and production for civilian use will be reduced. The effects upon everyday life, already experienced to some extent or in prospect even before December 7, will be more widespread and intensified. The fiscal problem will be greater in magnitude than before, and the danger of inflation more acute.

On the other hand, the open declarations of war and the defeat sustained at the beginning will in many respects make the armament effort more effective than heretofore. The nature of the war is better realized. The illusion of security is dispelled and public sentiment is united. A higher degree of co-operation and financial support unquestionably will prevail. People will submit themselves more readily to the measures needed, asking only that burdens be equitably distributed and that the country get ahead with the job.

Individuals and the Government

The Government rightfully has a prior call on all resources. It must also direct the war effort to insure that it will be co-ordinated and concentrated where necessary. However, the effectiveness of government action will depend upon the support given by the people. The more the policies of individuals accord with the needs of the war effort the less the Government will have to do and the better it will be done. The more people save and subscribe to government bond issues, the less inflation of credit and prices will occur. The more they economize in their consumption and refrain from hoarding, the less the competition of their demands with war production, and the less the need of government controls.

Extravagance is offensive in wartime, both because the Government needs the money and because the labor and productive effort needed to satisfy extravagant expenditures ought to be devoted to the war. In all wars people have found it hard to understand why they should not continue to spend according to their means, especially those whose means are suddenly increased by the wartime business activity and wage disbursements. But if the expenditure is unnecessary, and the article or service requires labor which is needed elsewhere, the expenditure ought not to be made. The pressure of high taxes should not be the only influence to promote individual economy; it should be supplemented and supported by voluntary co-operation.

Some may fear the effects of economy on the volume of business, but everyone agrees that shifts in industry are necessary and inevitable. If they are not enforced by reductions in the consumption of goods whose production competes with the war effort they will be enforced by shortages of materials and government regulations. In the aggregate there is not less business to do in the country; rather, there is more work than ever in sight. Of course expenditures will be shifted into new channels. The industries have to adapt themselves, as the automobile and rubber companies and countless others are doing.

Value of the Preparation for War

None of these principles is new. They have been applied to the situation for many months, but are now suddenly more urgent. The disturbance caused in the industries by the shift to all-out war will be moderated because it has been foreseen and planned for where possible, and has been under way for some time. The disturbance in every day life will be eased, because the production of consumers' goods for well over a year has been by far the greatest ever reached in this country, and consumers are well-stocked, merchants likewise in most lines. Their wants are now reduced accordingly.

Statements are being made to the effect that this stocking up in consumers' goods has been at the expense of the defense program, but these allegations hardly seem to take account of all elements in the situation. The fact is that the consumers' goods boom took place, for the most part, at a time when there was no other employment for the labor and machines involved, since arms designs and plants were not ready for mass production. The consumption of materials was not at the expense of armament output, for armament needs have had priority, and the shortages that come in the future will be borne by consumers, not by the arms factories. The more reasonable conclusion on the matter is that, while some plants undoubtedly could have moved further and faster in assuming armament work, on the whole the production of consumers' goods has eased a difficult transition, supported morale, and prevented an industrial disorganization and public alarm which would have impaired the ability of the country to make a supreme war effort.

The Inflation Danger

One other aspect of the responsibilities of individuals should be presented. Conditions are such that producers of many commodities, both agricultural and manufactured goods, many factory workers, and numbers of other people as well, could get higher prices for their goods and higher wages for their services, if they were free of restraints imposed by themselves or by the Government. Yet any general effort by these groups to improve their own position and standard of living by such means would inevitably be defeated, not only or perhaps even chiefly by government controls, but by the operation of the economic law. For if they raise the cost of the things they sell they will in due course raise the cost of the things they buy and their apparent gains will be lost. Meanwhile the inflationary spiral would be under way, and the entire economic situation would be raised on stilts, with collapse inevitable.

Much of the costly experience of the past twenty-five years, the great depression, the disorganization of trade, the wreckage of monetary systems, the destruction of billions of values, stems from the first world war. The problem is to avoid, as far as possible, a repetition. This will require a merging of individual interests into the general welfare. If this truth were accepted by all groups, and a philosophy of working and saving truly followed, the greatest possible step would be taken toward effective concentration on the war effort and control of the inflationary forces. The question is whether this is to be enforced by government upon an indifferent or uncomprehending people, in which case its effectiveness will certainly be low, or whether it is to be attained, under the guidance and leadership of government, by general and

whole-hearted cooperation, which is the highest expression of the association of free people.

General Business Conditions

The shock of war upon business was moderated by the extent to which the economic organization had already moved toward a war basis, and adjustments in the markets were orderly. There was no call or need for emergency action to allay panic or to keep the exchanges functioning normally. A rise got under way in prices of basic commodities which were still uncontrolled, but quickly ran its course, checked in part by instinctive unwillingness to expand commitments under the uncertain conditions, and in part by extension of price ceilings to new markets.

The pace of trade was slowed up noticeably for a time, and Christmas business was not up to expectations. It is difficult to say, however, how much this was due to a sudden change in buying psychology, and how much to the reaction from the anticipatory buying of earlier months. Doubtless the higher prices and excise taxes were also factors.

Strategic Materials from the Far East

Government agencies moved promptly to conserve supplies of the strategic materials affected by hostilities, to limit their use to essential purposes, and to assure their equitable distribution. The list of commodities imported from the Far East is a long one. It includes, among those now of first importance, Malayan and East Indian rubber, tin, quinine, spices, palm oil, and kapok, and Philippine sugar, hemp, coconut oil and chrome ore. If the Burma Road should be cut, supplies of Chinese tungsten, antimony, tung oil and pig bristles will be cut off. The shipping situation raises doubts as to future imports of Indian burlap, shellac, and goatskins, and possibly Australian wool, sheepskins and lead.

At best, supply lines will be lengthened by diversion of cargoes to the South Pacific or Good Hope route, and shipments may be slowed up by convoying. Shipping losses must be looked for. Policies must also take account of the worst to be expected, for the Japanese may succeed in closing the ports of the East Indies entirely.

Most of the commodities mentioned are being brought under complete government control. Nearly all our rubber and the greater part of our tin come from the Singapore area. Manufacture of rubber was suspended December 11 except for orders with A-3 priority rating or better, and certain other exceptions, and sales of tires except for defense purposes were prohibited while a rationing system was worked out. This system will take effect and sales will be resumed beginning January 5th, and the restrictions will be severe.

The country had a substantial supply of rubber in stock and safely afloat,—455,000 tons on hand and 173,000 tons afloat October 31, and doubtless more on November 30. Publication of statistics has now been discontinued. These supplies will take care of armament requirements plus minimum essential other uses for a long time, even if shipments from the East should cease entirely; and they will be supplemented by small receipts from other areas and by synthetic rubber production, which is expected to reach an annual rate of 80,000 tons by the end of 1942. However, it is manifestly necessary to eliminate all non-essential uses of rubber and to have strict economy in the use of tires. The transition will be eased for automobile owners by the heavy tire replacements made during the past year, by retreading, and to some extent by making low-quality tires of scrap rubber.

The tin stockpile also is large, sufficient for more than a year's needs if consumption were unrestricted, and of course consumption will be reduced by thinner tin coatings on cans and other economies. Ore from Bolivia and the Dutch East Indies is already stored here for smelting when the new Texas City smelter gets in operation in a few months. Demand for tin will be heavy. This country has made a commitment to supply the Latin American market with its tin plate requirements. The Department of Agriculture has set goals calling for a 15 per cent increase in four major vegetable packs—tomatoes, peas, beans and corn—to 114,500,000 cases compared with approximately 100,000,000 this year.

Conservation Measures

Measures designed to conserve burlap, hemp and bristles have been put into effect, and the O.P.M. has notified woolen and worsted manufacturers that during the first quarter of 1942 their use of new wool will be limited by a formula which will allow them about 100,000,000 pounds for civilian use for all purposes. This is a reduction of one-half in worsted manufacture and of 60 per cent in woolen goods, compared with the first quarter of 1941; but by mixing in old material the supply can be made to go further in terms of yardage.

The concern as to the wool supply is due wholly to uncertainty as to shipping. South American wool, in addition to our own production, can supply most of even our enlarged war-time requirements, and the stockpile is substantial. Nevertheless importations of Australian or South African wool would be necessary if consumption were unrestricted, and the conservation measure is a prudent move to protect reserve stocks.

Price ceilings have been put on fats and oils, and alternatives will have to be found for coconut and palm oil, which soapmakers value

for their free-lathering qualities, if shipments are long cut off. However, stocks on hand will last for a number of months, and fats and oils are interchangeable to a considerable extent. The total supplies of all fats and oils for 1942, including those from South America, will be adequate for all purposes.

The situation in sugar has aroused some alarm among consumers,—undoubtedly more than is warranted. The Philippines have supplied some 900,000 tons of sugar to this country during the past year, and this supply must be considered unavailable. But if any substantial part of the Hawaiian production can be brought to the West Coast the domestic crops and the West Indian and South American countries can supply all the sugar needed. Naturally the quota system will no longer operate to limit production, and inducements to increase output have already been given.

Negotiations have been completed with Cuban representatives for the purchase of the Cuban crop at a price of 2.65¢ per pound f.o.b., which compares with 2.26¢ on the last substantial sale of Cuban sugar to American refiners. At the same time the tariff on Cuban sugar has been reduced from 90¢ per hundred pounds to 75¢, so that only a part of the higher price will be paid by the American consumer. Allowing for shipping charges, the cost at the refinery will be about 3.75¢ and the present ceiling of 3½¢ on raw sugars will have to be raised accordingly. This in turn should bring a revision of the ceiling on refined sugar, which will act to stimulate domestic production; and benefit payments to small producers under the A.A.A. program have been increased in legislation extending the sugar program for three years.

Manufacturers' and distributors' stocks of sugar are large, following the heavy distribution of the past year, and the O.P.M. has taken steps to assure that these "invisible" stocks will be drawn upon to supplement the new supply.

Adjustments in Industrial Production

The new measures to conserve materials will affect operations in a good many industries, and particularly in rubber and automobile manufacturing. The limitations on passenger automobile production, heretofore chiefly for the purpose of reducing non-defense use of non-ferrous metals, will be determined henceforth largely by the rubber situation; and the December and January quotas, previously 48 and 50 per cent, respectively, under a year ago, were at once cut to 60 and 75 per cent. This will permit manufacture of 102,000 passenger cars in January. The February schedule, formerly 56 per cent under last year, remains to be determined. Other quotas for consumers' durable goods have likewise been reduced.

Demand for the products of many other industries, including cotton for tires, textiles for automobiles, and of course parts, accessories and metals, will be reduced by this curtailment. In many cases the reduction will ease congestion in the supply industries, but in others it will impose problems. It is likely that "priorities unemployment," notably in the Akron and Detroit areas, will reach greater proportions than previously estimated. Whether it is of long duration will depend upon how rapidly diversion to armament work of the plants and labor affected can be speeded. Undoubtedly there will be a time lag before the automobile industry itself can re-employ its displaced workers, although it has between \$4 and \$5 billions of government contracts.

However, the capacity for armament production is steadily increasing as new plants are completed and equipped, and there will be further calls for labor to extend the work week. The O.P.M. after the outbreak of war asked for a 24-hour day, seven day week in armament plants and defense industries. Many plants are already on that basis, or nearly so. Others responded immediately, and although the problems of obtaining and training the necessary labor and organizing the operation are difficult, many more will do so as time passes. Encouraging increases in armament output have already been reported.

Questions for 1942

If the outlook for 1942 were entirely a question of demand there would be no uncertainty, for the call upon the industries in the aggregate is limitless. The volume of arms production, however, will be governed not only by will or intent, but by ability to organize and coordinate the effort, to train labor, and to obtain materials. The Government has steadily extended its controls, and on the Government agencies falls the responsibility for coordination. The elements of the industrial organization for their part will have to pull together.

The prevailing sentiment among manufacturers and distributors of consumers' goods is one of hesitation. To some extent this is a normal reaction after the long period of stocking up, in which almost every one has participated. Also, it would be futile to try to buy far ahead in many lines, for few producers are in position to take the commitments. However, the hesitation goes deeper. Manufacturers do not know exactly where they stand. Distributors are uncertain as to consumers' attitudes. They are less willing to take inventory risks, in view of the danger, among others, of having price ceilings imposed upon them below current levels. They would like to know the effects of taxes, present and prospective, on buying power. A fundamental and unanswerable question is the length of the war. This uncertainty affects all planning.

Nevertheless, there is ground for believing that the production and distribution of consumers' goods in the aggregate will be large. The choice of goods available will be lessened, and there will be few replacements for many types of durable goods as they wear out; but even with a heavy diversion of effort to armament work, the essential requirements of living will be well supplied. The textile industries have enough raw materials to work to the limit of their labor supply and plant capacity, and there will be nothing approaching a shortage of food. Goals for livestock production are supported by good supplies of feedstuffs at prices profitable to feeders, dairymen and poultry raisers, and after allowing for heavy Lend-Lease shipments no one at home will have to forego the usual consumption. Purchasing power for necessities will be large, particularly in defense industrial and farm areas.

In the near future, while important industries are being forced to curtail, it will obviously be difficult to bring about any material expansion of aggregate industrial production. But as the changeover proceeds and new armament plants come into use, the probability of further increases as the year goes on is evident. The steel industry will have new capacity early in 1942, available to expand steel production if the necessary scrap supplies can be found; and airplane and ordnance manufacture and shipbuilding are strongly on the upgrade and need more labor. The machine tool industry, whose production must precede other industrial expansion, is still growing. Its output in 1941 will safely exceed the goal of \$750 millions; it is currently at the rate of \$900 millions annually, and the goal for 1942 is \$1,200 millions. Estimates of construction activity in 1942 have been revised upward since the outbreak of war, more defense plants and housing being expected.

Business observers generally will agree that the aggregate of industrial activity in 1942 will be substantially greater than in 1941, which was the most active year in our history. According to the Federal Reserve Board's index, industrial production in 1941 has exceeded the previous record year, 1940, by 26 per cent.

Money and Banking

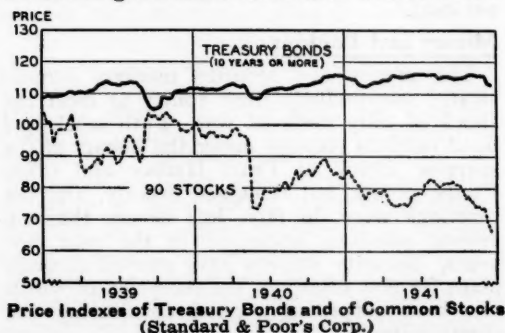
The money and security markets demonstrated impressively their ability to meet the shock of fully declared war. Both stock and bond markets recoiled under the impact of the surprise attack at Pearl Harbor and other Pacific points, but remained orderly, and the reactions were, in fact, less severe than on several previous occasions in the past few years. Security dealers have carried through plans for new offerings, the reception of which has been surprisingly good considering the circumstances.

Volume of trading in the stock market expanded following the Japanese attack, and representative averages of active industrial issues declined sharply under the first wave of selling. Although stock exchange, banking and government supervisory authorities were on the alert against possible emergency, the market quickly showed its ability to take care of itself. Prices rallied from the first impact, and while they subsequently drifted lower under a combination of influences, including unfavorable war news, tax selling, and uncertainties regarding future taxes, the market continued to function in a normal and orderly manner. There was a recovery at the close of the month.

Bonds acted similarly, except that price movements were narrower. Second and lower grade bonds, of course, followed the stock market pattern most closely. In the high grade list, United States Government securities showed losses ranging over 2 points for the month. Seasoned high grade corporation bonds likewise turned easier, with larger declines in some recently offered issues which had not been fully distributed.

Trading in government securities and high grade bonds generally was marked more by reluctance to place bids than by any great selling pressure. The Reserve Banks acted to stabilize the market in Treasury securities by taking over some \$12 millions of Treasury bills, of which \$2 millions was subsequently sold. Besides this moderate aid to the short-term market, some cushioning of declines in longer bonds was undertaken by means of Treasury purchases for account of government agencies and trust funds, and by Federal Reserve open market operations. While the volume of such buying by the Treasury for agency investment has not been revealed, the amount taken by the Reserve Banks in the two weeks ended December 24 was shown to have been about \$49 millions. This contrasts with the \$400 millions bought during the stabilizing operations at the outbreak of war in September 1939.

As shown by the following chart, last month's decline in government securities was consider-



ably less severe than occurred in September 1939, when prices fell as much as 9 points despite heavy supporting purchases by the Reserve Banks; and less severe even than at the time of the invasion of France in the Spring of 1940, when long Treasury bonds lost as much as 4 points.

The Treasury's offering of \$1 billion of new 2½s of 1967-72 and \$500 millions of new 2s of 1951-55 was fortunately timed, and subscription books were closed before the outbreak of war. Both issues were heavily oversubscribed, and in subsequent trading sold up to 102 22/32 for the 2½s and to 101 18/32 for the 2s. Both, however, reacted with the general market on the outbreak of war, though holding slightly above par with the help of Treasury and Federal Reserve support. At the close of the month the new 2½s, quoted a shade above par, were down over 3½ points from the peak of 103 20/32 reached by outstanding 2½s of the same maturity last October.

Sales of defense savings bonds expanded so rapidly after the outbreak of war as to temporarily exhaust the supply of bonds at many points. In the first twenty-seven days of December receipts turned into the Treasury totalled \$432 millions, or nearly double the \$238 millions for the full month of November. Thus December has clearly established a new high record for any month since the defense savings bonds were introduced, exceeding the heavy sales of last May when the campaign was started.

Money Rates Firmer

Even before the declines in bond prices following the outbreak of war last month, there had been a tendency for interest rates to work to somewhat higher levels. This tendency was at first largely confined to short-term securities, but in December the yields on practically all classes moved upward. The average yield on partially tax-exempt government bonds of more than 12 years maturity advanced from 1.85 to 2.02 per cent, while that on 3 to 5 year fully taxable Treasury notes (which had been as low as 0.62 per cent in September) rose from 0.94 to 1.04 per cent.

Prices of municipal securities, after having resisted for some time the firmer rate trend in short-term governments, tended to fall in line during the last few weeks of the year, yields on the shorter maturities increasing in many instances by 0.50 or more, with maturities longer than 10 years by 0.20 to 0.30. Following the same trend, railroad equipment trust financing done during the latter part of the month was on a yield basis appreciably higher than that for certificates of comparable grade issued three months earlier.

Average discount rate on new offerings of Treasury bills, which had been working up from practically no yield in October to 0.267

in November, reached 0.310 in December, the highest since October 1937. Open market offerings of commercial paper were made at slightly higher rates, especially the choice names, which moved from $\frac{3}{8}$ to $\frac{1}{2}$ per cent, while certain other names advanced from $\frac{1}{2}$ to $\frac{5}{8}$ per cent. Volume of commercial paper outstanding has been increasing, and the total on November 30 reported by the Federal Reserve Bank of New York was the largest in five years.

The firmer trend in money rates is a healthy development which, if allowed to go further, should aid in obtaining a broader distribution of new Treasury securities outside of the banks. This is necessary if we are to cut down the inflationary consequences of government borrowing and lessen the long-term hazards to the banking system of large scale commitments in securities at abnormally low rates of interest.

The Byrd Economy Report

With the outbreak of war bringing a stepping up in the program of defense spending to new and drastically enlarged objectives, the report last month of the economy committee, created under the last revenue act to study and recommend ways of cutting non-defense costs, comes at a most opportune time and is a forthright document. This committee, which is headed by Senator Byrd of Virginia and is composed of members of the Senate and House Appropriations and Taxation Committees, together with the Secretary of the Treasury and the Director of the Budget, has pointed the way to specific cuts in non-defense outlays during the coming fiscal year calculated to produce aggregate savings amounting to approximately \$1,700,000,000.

For a long time there has been talk of economy, but practically nothing has been done about it. With the immensity of the task ahead and its staggering cost now clear to everyone, it seems incredible that Congress should be willing to dilly dally longer on the question of immediate and vigorous retrenchment. Urgent as was the need for economy before, it becomes imperative now. As the committee states, "There is no room for non-essentials in a government stripped for action . . . The American people are being asked to pay extremely burdensome taxes which will become greater; they are being asked to make great sacrifice and endure hardships. The Government should set the example."

In the planning now being done for billions of expenditures and additional taxes, the elimination of unnecessary spending should be a primary and integral part of the program. A billion dollars saved goes as far towards cutting down the deficit as a billion dollars of new taxes, and is far less burdensome to the people and disruptive of the economy. Of course, we

shall need new taxes! But, as the statement above indicates, the people will bear their heavy burdens more cheerfully if the Government has put its own house in order, and if they know that the sacrifices they are called upon to make are really going to aid the defense of the country and not being frittered away in hand-outs to strongly organized pressure groups and in other extravagances.

The committee has rendered a valuable service in showing how a start can be made in cutting non-defense costs, but more needs to be done. With the latest budget estimates for this fiscal year, announced in October, showing approximately \$6½ billions of non-defense outlays, only \$1 billion below the all-time peak reached in the bonus year 1936, it is impossible to believe that additional ways for cutting such expenditures cannot be found.

According to an independent study along the same lines by the Brookings Institution, also made public last month, more than \$2 billions could be chopped from the budget "without trenching essential social services." It is encouraging, therefore, to have the Byrd committee's assurance that its studies will continue and that "other government departments, agencies, funds, programs and items will be examined by the committee and treated in subsequent reports."

In a press interview on December 30 the President stated that cuts were planned in a long list of non-defense expenditures, while Chairman Doughton of the House Ways and Means Committee called on the states and municipalities to cut expenses and taxes to give leeway for additional federal taxation.

Economic Changes in Japan

The boldness and vigor with which Japan has struck at many places simultaneously in the war of the Pacific have seemed at variance with the generally prevailing idea that she had been weakened severely by the four and one-half year struggle in China. In recent years her war expenditures and extensive capital investments in the newly conquered lands have been a heavy burden, leading to repeated predictions of imminent bankruptcy. Although Japan was the most industrialized and most powerfully armed country in the Western Pacific, it was widely assumed that she would not risk a major conflict because of her dependence upon imports of strategic raw materials and machine tools. When the economic blockade was applied against her last August, it was expected by many that she would have to curtail sharply her internal production.

Gradual discontinuance of the publication of economic data has made it difficult to get a balanced picture of recent economic changes in Japan. A number of basic changes are known to have taken place in the structure of

the national economy during the past decade. During the early Thirties a reorganization of her major industries was carried out and brought labor efficiency up nearer to Western standards. There has been considerable shift from light to heavy industries. A policy of developing natural resources in the conquered lands has been pursued intensively. Above all, Japan since 1937 has been building on an unprecedented scale those industries strategic to war.

These basic changes, which have resulted in an almost totalitarian regimentation of Japanese business, have been brought about in most cases by deliberate government policy and have entailed the use of methods strange to us. The significance of some of the measures characteristic of war-time economy may have been over-stressed; for example, the drastic restriction of civilian consumption during the first years of the war in China. That curtailment was generally regarded abroad as a sign of Japan's economic weakness, yet it now appears to have been part of the policy of economizing in order to build up reserve stocks. Numerous other symptoms, however, such as the loss of purchasing power of the yen, the rising costs and increasing difficulties of export trade, the unbalanced relations between industry and agriculture, the shortages of consumption goods and fuel materials, the signs of labor unrest and decline in labor productivity, the general shortage of workers, may be regarded as manifestations of strains which are likely to gather momentum under the burden of all-out war.

Japan is undoubtedly a much more powerful opponent than she would have been ten years ago, or even four years ago when she embarked on her vast armament program. She has achieved a greater degree of national self-sufficiency. Nevertheless she may have attempted to carry out too much in too short a period, while at the same time waging war in China. In a country as homogeneous and as proud as Japan, the evaluation of mere economic factors cannot serve as an accurate measure of the country's strength. The spirit and patriotism of the Japanese people, that have made them carry on thus far under burdens which might cause other peoples to falter, must also be taken into consideration.

Building the New Economic Structure

It should not be without significance to future peace makers that the seeds of the present conflict between Japan and the Allies lay, as in Germany, in the inability of liberal groups to carry out reforms and to deal with domestic depression problems. Japan had one boom shortly after the close of the First World War, while another was based rather precariously on the reconstruction following the big earth-

quake in 1923. The peak of post-war prosperity was reached in 1926, after which the inflated industrial and banking structure of the country began to contract. High costs resulted in the loss of export trade, on which Japan's internal and external purchasing power was dependent to a degree perhaps greater than any other modern industrial nation. The general collapse of international trade in 1929-30 made the situation worse and the Japanese found their principal export products excluded from one market after another by rising tariffs. By 1931, exports were down to less than 60 per cent of the 1926 level.

To the average Japanese, as to the average German, the only way out seemed to be through territorial expansion. The reaction against democratic and parliamentary methods—never rooted really deeply in Japan—gathered force simultaneously with the army's ascendancy. A wave of nationalism swept the country, and was exploited by the extremist elements in 1931 for the conquest of Manchukuo in the face of government opposition.

The successful coup in Manchukuo relieved temporarily the economic tension within Japan and encouraged further the military party. Increased government expenditure for armament, and a marked increase in foreign trade following the depreciation of the yen in 1931, resulted in a great expansion of industrial production and employment. Since the government deliberately refrained from burdensome taxation, new investments were encouraged, while older industries carried out a program of rationalization to lower costs, including labor costs, with the result that internal prices rose only moderately despite the depreciation of the yen to one-third of its former gold value. New capital issues aggregated almost 7 billion yen in the six year period 1931-1936. National income, which was about 9 billion yen in 1931, increased by nearly 80 per cent to 16 billions in 1936. Japan's recovery was perhaps the most extensive and rapid experienced in any major industrial country.

One of the most significant developments during the six years that separated the Manchukuan campaign from the war in China was the development of Japan's heavy industries. This was financed chiefly by corporations from their war profits, while larger export balances provided foreign exchange with which to pay for the necessary imports of machinery and tools. Between 1931 and 1937, Japan's steel output was more than trebled, as indicated by Table I.

The number of workers in the machinery industries, including shipbuilding, increased from 158,000 in 1931 to 602,000 in 1937, while the invested capital trebled. The volume of producers' goods doubled, and Japan became practically self-sufficient in regard to the pro-

Table I
The Yen Bloc Production and Imports

	Production				Imports				
	Coal (000,000 m. tons)	Non-fer. Ingots (000 s. tons)	Metals* (000 s. tons)	Mach. & Instru- ments† (000,000 Yen)	Iron Ore (000,000 m. tons)	Pig Iron Scrap (000,000 m. tons)	Crude Oil (000,000 bbls.)	Other Prod. (000,000 bbls.)	
1921	31.1	.8	75	568	.6	.2	—	—	
1929	43.5	2.3	112	808	1.9	1.0	10.0	2.5	
1931	40.0	1.9	118	498	1.5	.5	10.8	3.0	
1932	38.4	2.4	119	598	1.5	.8	13.5	3.3	
1933	45.3	3.3	120	888	1.5	1.2	14.6	3.4	
1934	50.8	3.9	123	1,159	2.1	1.6	17.7	4.2	
1935	54.4	4.9	130	1,462	3.4	2.3	21.9	4.6	
1936	59.9	5.6	148	1,716	3.8	2.2	24.6	4.9	
1937	66.1	6.5‡	174‡	2,557	2.3‡	3.3‡	16.0**	11.9**	
1938	77.0‡	—	200‡	3,801	2.5‡	2.3‡	21.3**	9.4**	
1939	—	7.0‡	212‡	—	3.5‡	2.2‡	16.1**	11.0**	

NOTE: Includes, up to 1931, Japan, Korea, Saghalien, Formosa and Kwantung; thereafter includes Manchukuo also. * Copper, zinc and lead. † Gross value; including shipbuilding. ‡ Figures incomplete, computed from export statistics of other countries. ** Exports from U. S. to Japan. ‡ Partly estimated.

ductive capacity for many individual steel products and industrial chemicals. There was even some surplus left for exports and by 1936 the share of older "textile" exports in the total dropped below 50 per cent.

The technological shifts in the Japanese industrial setup, however, were confined largely to the development of engineering trades and the building up of manufacturing capacity. Expansion of raw material supply was slower, since new railways and roads and even new cities had to be built before the exploitation in Manchukuo could start on a large scale. Some low grade iron ore reserves were opened, and mining was encouraged also in Korea and Formosa.

Thus, by and large, Japan was still dependent upon imported raw materials for her new capital goods industries when the war in China was started. Although Japan's economic structure became better balanced and the country more self-sufficient than before 1931, the industrial shifts actually increased her dependence upon many new raw materials, particularly metals and rubber.

Building of Industries Strategic to War

One of the reasons often cited for Japan's attack on China in July 1937 was fear of the growing unity of the latter country. Another was the desire to fit the Chinese industrial development into the Japanese economic program for Asia. The attraction of raw material wealth, particularly cotton and coal in Northern China, was probably as strong as the desire to find an outlet for the products of Japan's new capital goods industries, the capacity of which began to exceed domestic requirements.

Quick victory over China did not materialize however, and by 1938 it became obvious that Japan was involved in a long drawn-out conflict. With the demands from the fighting services growing, Japan's efforts naturally turned to the building of a vast armament

industry. The country's economy, relatively free of army interference up to 1937, subsequently became completely dominated by the military requirements. The period of more or less balanced development, in which consumption industries participated, came to an end.

The ambitious task which the Japanese people undertook might have been possible to carry out over an extended period, but in the short time which they have given themselves it has become almost super-human. Japan's Four Year Plan formulated early in 1939, for example, called for an increase in steel capacity by 1942 of 60 per cent over the 1938-39 output, a thirty-fold increase in the output of synthetic gasoline, and ten-fold in aluminum and magnesium output. No less ambitious was the Manchukuan Five Year Plan adopted in 1937, which anticipated an increase in iron ore production of 400 per cent to 12,000,000 tons, and in pig iron of 650 per cent to almost 5,000,000 tons.

In addition to building up the armament industry, which entailed the construction of nonferrous metal smelters and of specialized engineering plants, the armies in the field had to be supplied and natural resources developed at a pace faster than ever before. An extra ten million tons of coal, for example, were needed to produce some two million tons of synthetic gasoline and oil. Production of aluminum and chemicals required the development of electric power production on a vast scale.

Transition to War-Time Economy

To carry out these plans, Japan proceeded to divert step by step an increasing share of national production to the war industries. In an effort to save as much foreign exchange as possible for the purchases of raw materials and capital goods for armament industries, a complicated control of foreign trade was instituted and made more and more rigorous as time went on. Following the passage of the Materials Mobilization Program in the Summer of 1938, corresponding to our priority program, the use of domestic raw materials and manufactures also came under regulation. Finally, in the last few years, the shortage of labor also contributed materially to the curtailment of output of non-essentials.

The cumulative effect of the declining output of consumption goods began to appear after about two years of war in China. Rationing of lumber and metals slowed down residential building construction, at the time when country labor was flocking to armament factories in the cities. Restrictions on the use of pulp and paper upset some of the export industries. Shortage of fertilizers contributed to the lowering of crop yields. Even substitute supplies of rayon and staple fibre for the domestic market—to replace imported cotton and wool—came

to be reduced in order to export more. Scarcity of clothing materials and leather for footwear is said to have been a serious factor in lowering labor efficiency.

Expansion of exports to other countries of the Yen Bloc also contributed to the growing scarcity of goods. This development was the consequence of large investments, which in the case of Manchukuo exceeded one billion yen per year by 1939. It also reflected a greater degree of inflation, owing to heavy army expenditures, in those regions than in Japan proper.

By 1939 it became evident that most of the gains of the first half of the Thirties were lost and that living standards had fallen back to the depression levels. Since that time, practically every article of human consumption, ranging from clothing to rice and fish, and even charcoal (for cooking) and coal have come to be rationed.

Government Finances and Inflation

The fear of inflation was probably an important consideration in the extension of rationing. While output of consumption goods was steadily declining, the monetary purchasing power generated by army expenditures in China and by armament costs was expanding. The sharp rise in budgetary expenditures since 1937 may be seen from the accompanying table.

It has been estimated that the cost to the Japanese people of the war in China is exceeding 40 billion yen. Since the Japanese tax base is very narrow (it has been estimated that 84 per cent of families have an annual income of less than \$400 per year) the huge expenditures had to be financed principally through government loans placed with commercial banks and through reinvestment of profits by industrial corporations. The sharp run-up in bank deposits may be seen in the table.

The internal debt, which grew from about 6 billion yen in 1931 to about 10 billions in 1937, approached 30 billions by April 1, 1941, the beginning of the present fiscal year. According to Otto D. Tolischus, the New York Times correspondent in Tokyo, the debt has been accumulating since last Summer at the rate of about one billion yen per month, and in view of increased appropriations for war probably exceeded 35 billion yen at the time of the outbreak of the Pacific war.

Since the start of the war in China, Japan has tried many different types of price control. In October 1939 a blanket order freezing all prices, rents and wages, was put into effect. Nevertheless, prices and wages have continued to increase. As will be seen from Table III, weekly wage earnings rose nearly 70 per cent between 1936 and the Spring of 1941, while retail prices advanced about 65 per cent.

Table III
Indexes of Japanese Wages and Prices
(1931 Average = 100)

Annual Average	Wage Rates	Weekly Earnings	Wholesale Prices Domestic	Wholesale Prices Imported	Retail Prices	Value of Gold in Yen
1926	110	110	a	a	147	106
1929	109	114	a	a	134	108
1930	105	109	a	a	115	101
1931	100	100	100(b)	100(b)	100	100
1932	97	97	103	124	101	177
1933	93	98	111	151	107	250
1934	91	100	119	154	110	278
1935	89	100	123	156	112	294
1936	89	101	130	161	118	291
1937	90	107	144	201	129	292
1938	93	116	157	220	147	296
1939	102	131	179	241	165	324
1940	111	148	198	266	193	361
1941	116(c)	167(c)	198(d)	271(d)	196(f)	361*

Source: Mitsubishi Monthly Circular, and Oriental Economist. (a) Not computed. (b) Dec. 10, 1931 = 100 (the date on which Japan left the gold standard). (c) March 1941. (d) February 1941. (f) May 1941. * October 1941.

Table II
Japanese Government Finances, National Income and Banking Statistics
(In Millions of Yen)

Fiscal Year (March 31)	Defense Expenditures Regular	Defense Expenditures Special	Total Expenditures	Tax Receipts	National Bonds Outstanding(a)	Calendar Year	National Income	Notes in Circulation(b)	Bank Deposits(c)	New Capital Issues	New Manchukuo Investments
1925-26	444	.....	1,525	886	5,901	1925	13,382	1,541	8,866	1,307	.....
1929-30	506	.....	1,736	894	5,959	1929	11,920	1,591	11,847	1,043	.....
1930-31	443	.....	1,558	835	5,955	1930	10,636	1,436	11,058	457	.....
1931-32	455	.....	1,477	736	6,187	1931	9,186	1,330	10,828	558	.....
1932-33	687	.....	1,950	696	7,054	1932	9,959	1,426	10,247	439	97
1933-34	873	.....	2,255	749	8,139	1933	12,064	1,544	11,078	1,136	151
1934-35	942	.....	2,163	843	9,090	1934	13,044	1,628	11,823	1,334	272
1935-36	1,033	.....	2,206	926	9,854	1935	14,532	1,766	12,417	1,427	379
1936-37	1,078	.....	2,282	1,052	10,574	1936	16,320	1,865	13,283	2,000	263
1937-38	1,237	2,540	5,249	1,432	12,817	1937	20,476	2,305	14,690	3,627	348
1938-39	1,167	4,850	7,821	1,984	17,344	1938	22,518	2,754	17,084	3,976	440
1939-40	1,629	4,605	8,563	2,495	22,886	1939	25,500	3,679	21,289	5,308	1,104
1940-41	2,305	5,460	11,034	3,164	29,252(d)	1940	30,000(e)	4,777	27,012	4,470	1,010
1941-42(f) ..	3,250	4,880	12,205	3,691	(g)	1941	35,000(e)	4,332(h)	34,521(h)	.....	.....

Sources: Compiled from Mitsubishi Monthly Circular, Oriental Economist, E. B. Schumpeter: The Industrialization of Japan and Manchukuo, and other sources. (a) Does not include external debt of ¥1,245,000,000 on Dec. 31, 1940. (b) Bank of Japan only. (c) Annual averages, excluding Bank of Japan. (d) February 1941. (e) Estimated. (f) Budgetary estimate made a year ago, and since then raised to about ¥20,000,000,000 for total expenditures. (g) Estimated to exceed ¥40,000,000,000 by March 1942. (h) July 1941.

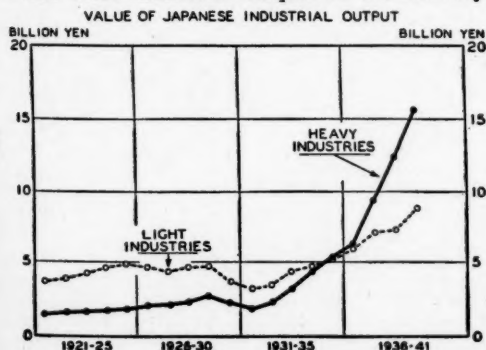
Undoubtedly a certain amount of inflationary price rise was not unwelcome, since it served to check civilian consumption in a country having a narrow tax base. There is reason to believe, however, that agricultural prices and wages may have got out of line, principally as a result of the exhaustion of rural labor reserves.

Mass conscriptions for the army and the boom in armament industries caused an acute shortage in skilled labor. Since practically full employment of the labor reserve had been reached already in 1937, it was necessary to attract labor to armament industries by an almost continuous process of raising wages. As in Germany, the industries making synthetic substitute materials have become almost insatiable in their demand for labor.

This shortage of labor had a serious repercussion on agriculture and, in combination with other factors such as the shortage of fertilizers, has led to an actual decline in crop production. At the same time, the growing urban population has provided a larger demand. With agricultural wages more than doubling since 1937, costs have also increased. To keep agricultural prices from rising too fast, the Japanese Government has been paying subsidies to cover part of the cost of production. Moreover, more food had to be imported from the surplus rice producing countries, such as Thailand and Indo-China.

Bottlenecks and the Armament Program

The extent of the realization of Japan's vast armament program at the time of the outbreak of the war in the Pacific, paid for so heavily by the restriction of civilian consumption, cannot of course, be accurately gauged here. The records available indicate a sharp rise up to the middle of 1940 in the employment of metal, machinery, electrical equipment and chemical trades. Value of the output of heavy and chemical industries doubled in the four years ending 1939, as will be seen in the accompanying chart, and comprised more than 60 per cent of the total industrial output of the country.



Imports of nonferrous metals, especially copper from the United States, had also risen sharply up to the time of embargo.

In comparison with the United States, the industrial power of the entire Yen Bloc has remained small. For example, the steel capacity was expected to reach about 11 millions tons by 1942, but a substantial part will probably remain idle owing to lack of raw materials. In the year 1940, the Japanese combined production and imports of machine tools was reported to be valued at about \$70,000,000, compared with U. S. production in 1941 of around \$750,000,000. Production of coal within the Yen Bloc probably does not exceed 90 million tons, occupied China excluded. Japanese production of petroleum products (natural, synthetic and substitutes) has been estimated at around 15,000,000 barrels in 1940, as against consumption variously estimated from 25,000,000 to 40,000,000 barrels.

Industrial bottlenecks began to assume important proportions by 1939, which was of course natural in a country where the armament industry was being built on thin resources. Lack of skilled labor was one of them. In the Winter of 1939-40, a coal shortage necessitated staggering of factory production. The embargo on our machinery and tool exports to Japan since the Summer of 1940, and the inability to obtain German tools and equipment, have slowed down the exploitation of a number of raw material resources. Plans had to be revised, and it is reported that the construction of several new coal hydrogenation plants has been abandoned altogether. Obstacles to the flow of production must have further increased following the imposition of the trade embargo last August.

Our Maximum Effort Called For

From the foregoing facts, it is apparent that the Japanese program of industrial and armament expansion has gone much further than has been generally realized. Even so, Japan's industrial capacity, of course, is far less than we can bring to bear, if and when we can get the same degree of concentration upon war materials and supplies. Whether the growth of Japan's industrial and war power may not have been so rapid and inflation so severe that points of serious weakness may develop remains to be seen. There are evidences that their peak of total production may have been reached in 1939. But we cannot count upon that for victory.

As Prime Minister Churchill said in talking about Germany at a White House press conference, while a collapse from internal pressures before military defeat would be a windfall, we cannot bank on that but must plan on an external knockout.



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